PERAC

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2001 It was a year marked by terrorism, war, a global recession, and the second consecutive year of losses for most stocks. Despite the challenges and obstacles, the turn of the year appeared to carry a sense of optimism and hope that 2002 would be a year of recovery for the economy and for the market.

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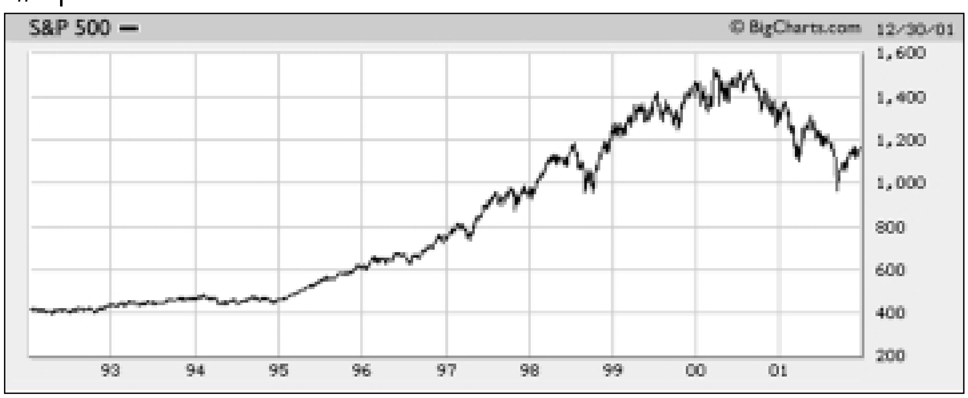
The equity market, despite an impressive rally in the fourth quarter, finished its worst two-year period in almost 30 years.

AFTER THE YEAR 2000 BROUGHT A VICIOUS CONCLUSION TO THE BULL MARKET OF THE 1990S, FEW STRATEGISTS FORESAW THAT 2001 WOULD BRING MORE OF THE SAME. Yet, that is what occurred as the equity market, despite an impressive rally in the fourth quarter, finished its worst two-year period in almost 30 years. While some asset classes continued to provide positive returns, they could not offset the weakness in stocks and it was difficult for any public or private pension fund in this country to avoid a year of negative return and once again fail to meet its actuarial investment objective.

The economy had begun to slow following the bursting of the NASDAQ bubble in March, 2000 and, by the spring of 2001, the US was officially in a recession. In an unprecedented course of action, the Federal Reserve aggressively reduced rates eleven times throughout the year. The Federal Funds rate was cut by 4.75% to 1.75%, the lowest level in forty years, yet the economy was showing only mixed signs of recovery by year-end. The additional stimulus offered by tax cuts and rebates along with sharply lower oil prices have also proved ineffectual to date.

The economic contraction had been spurred by a sharp decline in corporate

#1 | THE S&P 500: A TEN YEAR PERSPECTIVE



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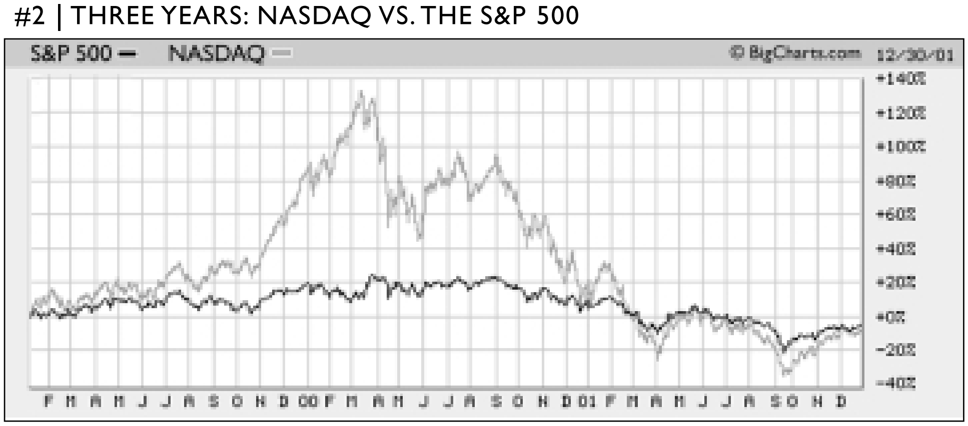
#2 | THREE YEARS: NASDAQ VS. THE S&P 500



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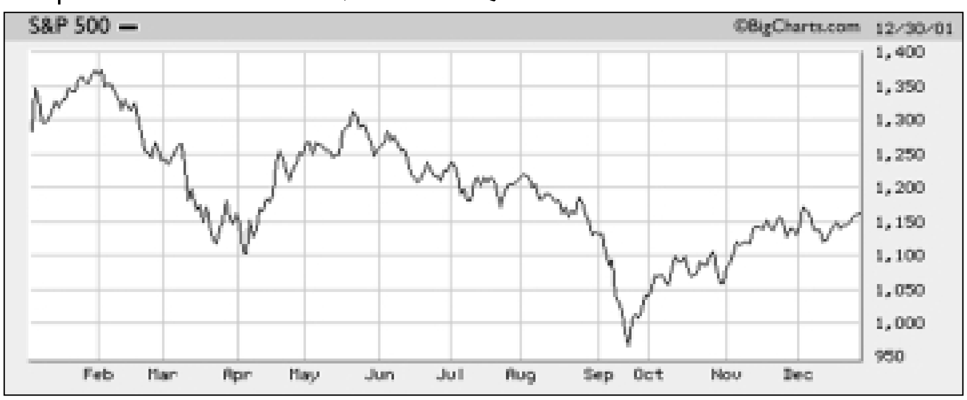
investment arising from a severe overcapacity that had developed, particularly in various "new economy" sectors victimized by severely over-optimistic business models. For most of the year, consumer spending had held up surprisingly well, but it too suffered a severe drop in the aftermath of the September 11 terrorist attacks. Overall, almost 25% of the country's industrial capacity was unused at year-end, and the unemployment rate had risen to 5.8%, the highest level since May, 1995. Since January, 2001, when the unemployment rate had been 4.0%, 2.6 million jobs were lost during the course of the year.

#3 | THE MARKET IN 2001; FOURTH QUARTER RECOVERY



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#4 | THE RISE AND FALL OF TECHNOLOGY STOCKS

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The fourth quarter was indeed a positive one as the markets rebounded strongly from the post-attack low reached on September 21. Even with its 10% quarterly advance, however, the S&P 500 Index of large cap stocks was off 13% for the year, its worst annual loss since 1974 and capping its worst two-year period since 1973-74. Even after rising 37% from its low and 30% for the quarter, the NASDAQ Composite still declined over 20% for the year. Following its 39% rout in 2000, the NASDAQ—at 1950—was 61% off its 2000 high of 5048. Small caps were the place to be as, following its 21% rise during the fourth quarter, the Russell 2000 registered a positive 1% return for the year. Midcap stocks also generally outperformed large caps both for the quarter and for the year. (See table on page 6.)

Among all subclasses and styles, small cap value was 2001's undisputed champion. Overall, growth stocks outperformed value during the fourth quarter but still trailed for the year, with margins particularly wide in midcaps and small caps. After two years of significant relative recovery following the debacle of the late 1990s, value stocks may well have caught back up to growth in terms of intrinsic value. (See table on page 6.)

Among industries, consumer discretionary stocks (+1.9%) and materials (+1.0%) were the only two out of the eleven sectors of the S&P 500 to register a positive return for 2001. Utilities, hurt by sharply falling oil prices as well as ripple effects from the Enron bankruptcy, suffered the worst performance (-32.5%). Although a few software companies held up relatively well, information technology firms had another brutal year, down a composite 26%, as did the overbuilt telecommunications sector, down 13.7%. In addition to the overcapacity problem, the tech sector suffered from a lack of dynamic new products.

Besides the collapse of Enron, the largest bankruptcy in US history, the year saw the end for a host of previously high-flying but now fatally overextended telecom companies as well as filings by some well-known, established companies like Polaroid.

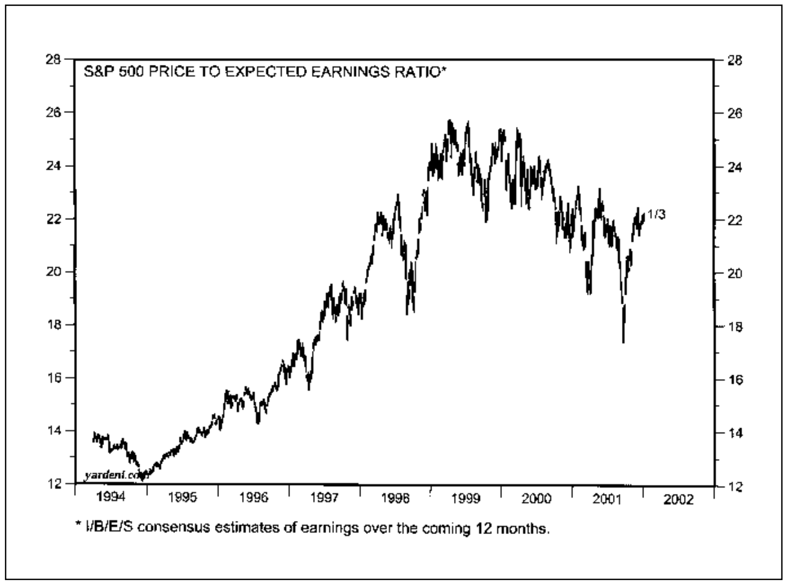
Strategists struggled to explain why the market, contrary to most historical observations, has failed to respond more dramatically to the Fed's aggressive easing. The answer likely lay in the fact that while stock prices have fallen significantly on an absolute basis, they have declined very little relative to earnings. Price to earnings ratios remain well above historic norms for market bottoms. Furthermore, despite their two-year swoon in stock prices, tech stock valuations remain well above those of the overall market. (See charts 5 and 6.)

Although most countries, with the notable exception of Japan, participated in the fourth quarter rally, 2001 proved to be another disappointing year for international stocks. Terrorism, war, and, most of all, a global recession, could not be overcome as the Morgan Stanley EAFE Index fell 22% for the year. For the first time in 30 years, the US, Europe, and Japan were all in recession simultaneously. There were some bright spots—including Mexico, South Korea, and Russia—but, in general, no region was able to buck the overall trend. Japan, paralyzed by stalled economic reforms and a weak banking system, remained mired in its worst recession since World War II while Argentina's profligate fiscal practices led to its default on debt payments in December.

It is advantageous for US investors in foreign stocks when the local currency is strong. Thus, the surprising continued strength of the US dollar added to the magnitude of losses from foreign markets. In looking past the immediate dire effects of the terrorist attacks, the currency markets seemed to be giving a vote of confidence to the Federal Reserve, anticipating that its proactive monetary easing would serve to restore and maintain the US economy as the most dynamic and productive in the world.

For only the fourth time on record, bonds outperformed stocks for the second

#5 | PRICE/EARNINGS RATIOS REMAIN HIGH



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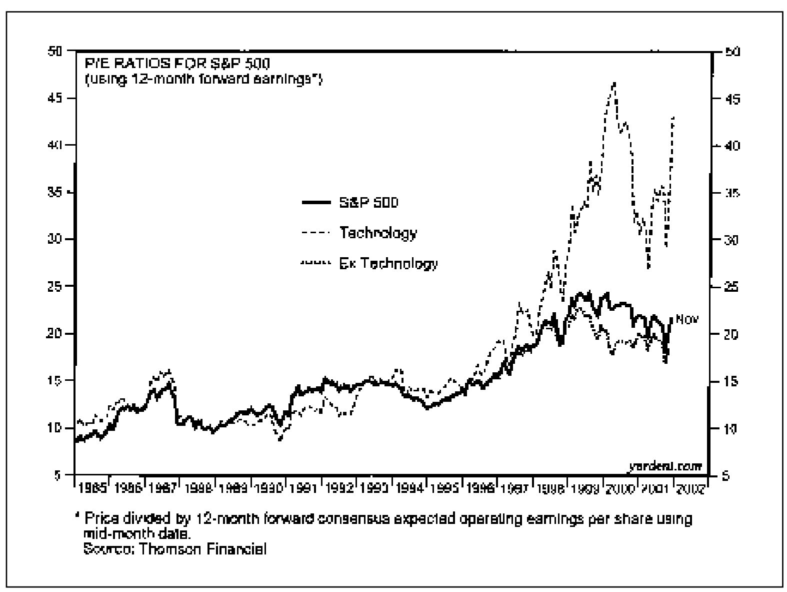
#6 | TECH STOCKS STILL APPEAR EXPENSIVE



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straight year. Returns, while positive, were not as high as in 2000, however, reflecting weakness at the end of the year as investors took profits in expectation that an economic recovery would begin to reverse the trend toward lower rates (which bring higher bond prices). The Lehman Brothers Aggregate Index was flat for the fourth quarter and up 8.4% for the year. At year-end, the US Treasury yield curve was unusually steep, meaning that long-term interest rates were sharply higher than short-term rates, a situation usually indicative of favorable economic growth prospects. (See chart 8.) For the year, yields on 10-year Treasury bonds fell only slightly from 5.11% to 5.02% after achieving a low of 4.20% in the fall. Thirty-year rates were essentially unchanged for the year at 5.47%; they had been as low as 4.70%. (The Treasury surprised the market by announcing that issuance of thirty-year securities, long the benchmark for the bond market, would be suspended.) In contrast, rates on two-year notes declined from 5.09% to 3.04% in sympathy with the Fed's easing. Corporate bonds continued to offer an attractive yield increment over Treasuries as the market remained skeptical over prospects for economic recovery. (See chart 9.) Despite an increasing default rate, high-yield ("junk") bonds held up reasonably well, supported by the cushion of a large 7% yield advantage over Treasuries.

Although not immune from the effects of an economic recession, real estate also provided its second consecutive year of positive returns in the face of a weak stock market. In commercial real estate, vacancy rates rose, market rents fell, and tenants actually leased less office space than the year before. However, the strength of existing leases, as well as the benefits of a market in general equilibrium between supply and demand, were sufficient to help real estate investments achieve favorable results. Publicly-traded REITs rose an aggregate 5% during the fourth quarter and 14% for the year; the sector received a boost from the inclusion of two REITs into the S&P 500 Index for the first time. Privately-held real estate appeared to be producing reduced but still positive returns through the third quarter. One segment of the real estate market that was under clear pressure was hotels, hit hard by the sharp decline in travel and leisure spending following September 11.

#7 | INTEREST RATES ARE HISTORICALLY LOW

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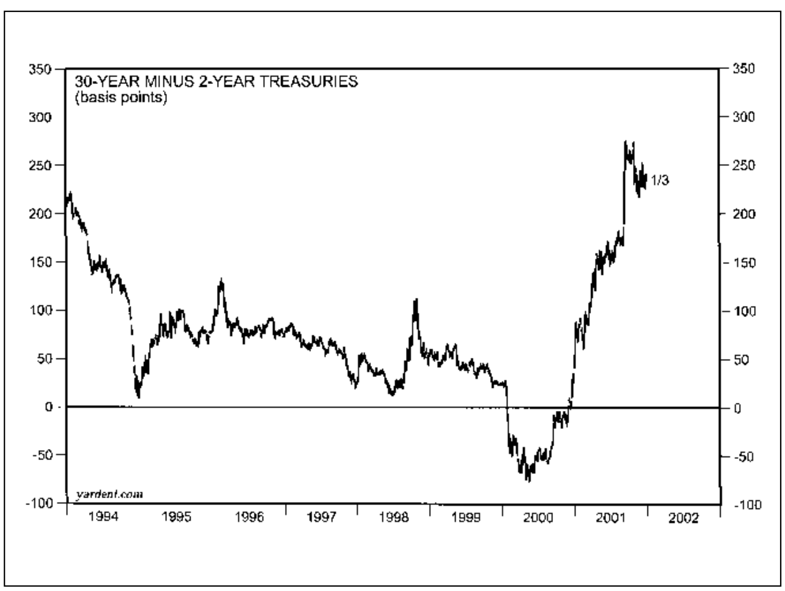
#8 | THE YIELD CURVE IS HISTORICALLY STEEP



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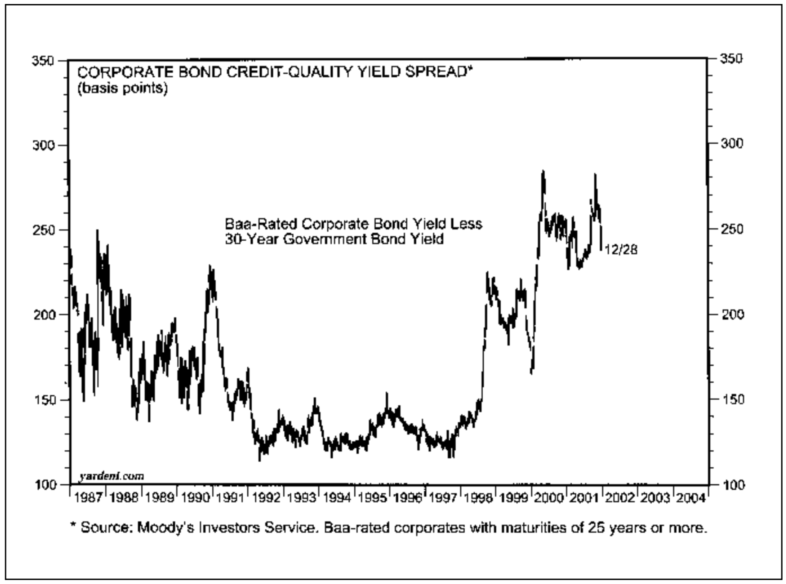
Composite performance results will not be available for some time but anecdotal evidence indicates that 2001 was a year of painfully negative returns for most venture capital partnerships. Investments from prior years were still being marked down to realistic levels, and about 80% of new investment by partnerships went to nurture existing company holdings rather than to fund new companies. Through the twelve months ending September 30, investment in new companies was down almost 50% from the prior year. The Initial Public Offering (IPO) market remained virtually closed in 2001, with only about one quarter the offerings as in 2000, and most of those that did come to market were for established companies rather than start-ups. If venture partners saw any light on the horizon, it was that a return to traditional investing discipline should provide more stable returns in the future.

The year 2002 began on an optimistic note as the US appeared to have achieved most of its military objectives in Afghanistan, there were some indications that the end of the recession may be in sight, and the stock market began the year on a positive trend. However, with price/earnings ratios unlikely to rise substantially from current levels, it was apparent that any meaningful rally would have to be based on rising corporate profits. With year-end sales accomplished largely through price-cutting, a major expansion of corporate earnings could be quite difficult to achieve.

Market optimists could also take some solace in history. While the just-concluded two-year down market for stocks was the first in almost 30 years, it's been a full sixty years—dating from World War II and the US entry into that conflict—since the market declined for three consecutive years. ■

As always, we welcome your comments on this report and encourage your suggestions for future investment research reports. For those systems that would like to discuss their portfolios and strategies in the context of the current market or to talk about any other relevant investment topics, we would welcome an invitation to attend one of your board meetings.

#9 | LOWER QUALITY BONDS ARE ATTRACTIVE



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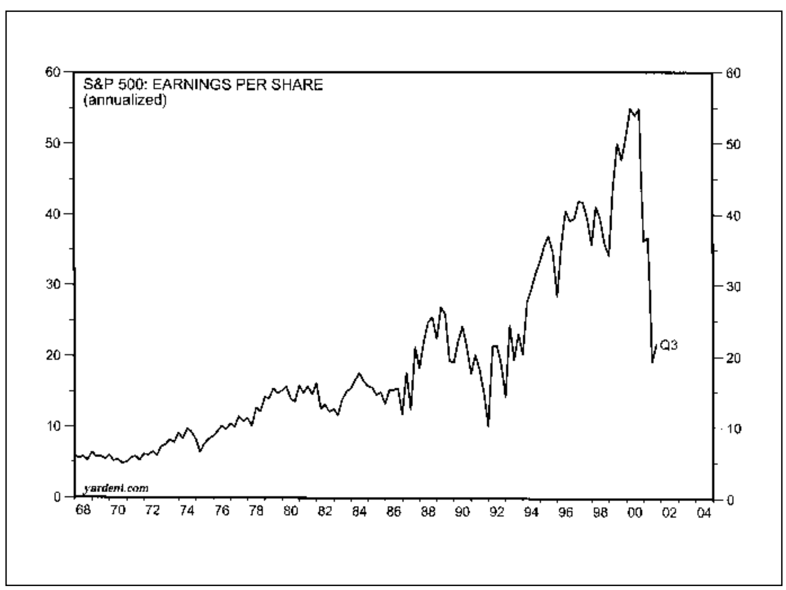
#10 | CORPORATE PROFITS HAVE PLUMMETTED



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TOTAL RETURNS | *FOURTH QUARTER, 2001*

INDEX	FOURTH QUARTER 2001	TWELVE MONTHS 2001
US EQUITY MARKET		
Dow Jones Industrial Avg.	+13.84%	- 5.43%
Standard & Poor's 500 (Large Cap)	+10.69%	- 11.88%
NASDAQ Composite	+30.13%	- 21.05%
Wilshire 5000 (Broad Market)	+12.37%	- 10.97%
Standard & Poor's Mid-Cap 400	+17.99%	- 0.61%
Russell 2000 (Small Cap.)	+21.09%	+ 2.49%
GROWTH VS. VALUE		
S&P 500 Growth	+13.02%	- 12.73%
S&P 500 Value	+ 7.96%	- 11.71%
Russell Midcap Growth	+27.06%	- 20.15%
Russell Midcap Value	+12.03%	+ 2.33%
Russell 2000 Growth	+26.16%	- 9.23%
Russell 2000 Value	+16.72%	+14.03%
INTERNATIONAL EQUITY		
M.S.C.I. - E.A.F.E.	+ 6.98%	- 21.21%
M.S.C.I. - Emerging Markets	+ 26.61%	- 2.37%
FIXED INCOME		
Lehman Brothers Aggregate Index	+ 0.05%	+ 8.43%
Lehman Brothers Government/Credit Index	+ 0.06%	+ 8.50%
First Boston High Yield Index	+ 5.65%	+ 5.78%
REAL ESTATE		
NAREIT - Equity Real Estate Investment Trusts	+ 4.98%	+13.93%
NCREIF Property Index	+ 1.58% (Q3)	+10.09% (Trailing)

GLOSSARY

Dow Jones Industrial Average
A price-weighted index tracking 30 large industrial companies selected by the editors of *The Wall Street Journal*.

Standard & Poor's 500 Index
A broad-based market index, weighted by market capitalization, that comprises about 75% of the total market value of publicly traded US equities.

NASDAQ
The National Association of Securities Dealers Automated Quotation System is an over-the-counter trading exchange used mainly by newer, technology-oriented companies.

Russell 2000
The major index that tracks small capitalization stocks.

Large Capitalization Stock
Total market value of outstanding stock exceeds $5 billion.

Mid-Cap Stock
Between $1.5-5 billion in market capitalization.

Small-Cap Stock
Less than $1.5 billion market value of stock outstanding.

Growth Stock
Stock of companies that, due to their strong earnings potential, offer above-average prospects for capital appreciation, with less emphasis on dividend income.

Value Stock
Stocks that, considering a company's assets and earnings history, are attractively priced relative to current market standards of price-to-earnings ratios, price-to-book ratios, et al. They typically pay regular dividends to shareholders.

Price/Earnings Ratio
Sometimes referred to as the "multiple", the P/E Ratio is the stock price divided by the company's net income per share over the past twelve months.

Treasury Yield
The current market interest rate on bonds issued by the US Treasury with a specific maturity date (i.e. 30 years). Bonds are issued at a specific interest rate and at a specific price (such as 100 or "par") but the subsequent price and yield will be determined every day by prevailing market conditions. If rates generally rise (fall) after initial issuance, the price of the original bond will fall (rise) in order to make the effective yield on the bond rise (fall) to a level consistent with those on currently issued securities.

GLOSSARY *(CONTINUED)*

Corporate Bond Spread The "spread" is the incremental yield offered by corporate bond issuers over those of US Treasury securities of similar maturity. The spread is a measure of investors' willingness to assume the extra credit risk inherent in corporate securities compared to virtually riskless US Treasuries.

Federal Funds Rate The rate at which reserve funds ($1 million or more) are traded among commercial banks on an overnight basis.

High-Yield ("Junk") Bonds Bonds rated below investment grade issued by corporations whose overall business or financial condition is relatively weak or risky. These bonds react less to general interest rate trends than do investment grade securities.

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